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No. 81-2394

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

WESTINGHOUSE ELECTRIC CORPORATION,
Appellant,

-against-

JAMES H. TULLY, JR., *et al.*,
AS THE TAX COMMISSION OF THE STATE OF NEW YORK,
Appellees.

APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK

BRIEF IN OPPOSITION TO THE MOTION TO DISMISS OR AFFIRM

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The arguments advanced by New York State in attempting to justify its scheme for taxation of Domestic International Sales Corporations ("DISCs") fail to meet appellant's constitutional objections. Indeed, the State virtually admits that it is using taxation of Westinghouse Export to levy taxes on income earned by Westinghouse affiliates that it otherwise could not tax. Because the State lacks a sufficient nexus with these non-New York affiliates to allow it to tax them, the tax imposed by appellees violates the Commerce Clause and the Due Process Clause of the Fourteenth Amendment.

Additionally, and wholly apart from the Due Process violation, the tax is inconsistent with the Federal objective to

give tax benefits to DISCs to encourage domestic manufacture of products for export. It is inconsistent because it imposes a state tax on accumulated DISC income on which Congress has deferred tax in order to promote exports. For that reason it also violates the Commerce Clause.

Finally, the credit that New York allows against a portion of the tax otherwise due on account of DISC income is a further, independent, constitutional violation. The State has offered no justification for this credit, which penalizes international trading activities conducted from locations outside New York and rewards those conducted in New York. Such discriminatory taxation based on the location of economic activity violates the Commerce, Due Process and Equal Protection Clauses. Moreover, by encouraging export products to be shipped from New York, the State is attempting to increase the allocation percentage that it can then apply to tax non-New York affiliates through the DISC.

When all of the confusing explanations are swept away, the State's argument boils down to the claim that all of the defects that appellant has identified in the New York tax are obviated by the use of a fair apportionment formula to determine what portion of Westinghouse's income is taxable by New York. But the fact that the formula in and of itself is proper does not meet appellant's challenges. Our claim, as reiterated below, is that the formula is being applied to income that the State has no business taxing at all.

I. THE NEW YORK FRANCHISE TAX IS UNCONSTITUTIONAL BECAUSE IT IS EFFECTIVELY LEVIED ON INCOME HAVING NO NEXUS WITH THE STATE AND BECAUSE IT FRUSTRATES THE CONGRESSIONAL PURPOSE TO ENCOURAGE FOREIGN COMMERCE.

A. For purposes of analyzing constitutionality of New York's tax structure in light of the State's position here, the structure of Westinghouse's business can be divided into three relevant parts: (1) Westinghouse Electric Corporation ("West-

inghouse"), the appellant here and the taxpayer under New York law; (2) Westinghouse Electric Export Corporation ("Westinghouse Export" or "Export"), Westinghouse's wholly-owned DISC subsidiary; and (3) a number of firms affiliated with Westinghouse that—by appellees' admission—did not do any business in New York State during the years in question ("non-New York affiliates").

The State admits that the income of the non-New York affiliates must be "excluded from New York tax" (Motion to Dismiss at 13). It further admits that "[t]he income of Westinghouse [Export] attributable to affiliates of Westinghouse which do not do business in New York is not subject to New York taxes . . ." (Motion to Dismiss at 17). These concessions are required by the Commerce and Due Process Clauses, since the State has never claimed that the non-New York affiliates are part of a unitary business with Westinghouse.[1] *See ASARCO Inc. v. Idaho State Tax Comm'n*, 50 U.S.L.W. 4962 (U.S., June 29, 1982); *F. W. Woolworth Co. v. Taxation and Revenue Dep't*, 50 U.S.L.W. 4957 (U.S., June 29, 1982).

Appellees go on to claim that this income—wholly unrelated to New York—"is not taxed" by the State (Motion to Dismiss at 17). In this, appellees are wrong. For in calculating the amount of Export's income subject to New York tax, appellees include in the income base Export's entire net income, including the 20-25% earned in respect of Westinghouse's non-

[1] Indeed, the same State Tax Department Field Audit Report that recommended taxing Westinghouse on all of Export's income expressly recognized that Westinghouse's other "subsidiaries are in general, autonomous in nature with employees of their own and independent places of business. Merchandise transactions are consummated at the equivalent of 'arms length' and the taxpayer [Westinghouse] is reimbursed by its subsidiaries for services rendered on their behalf. No distortion to the New York Tax base from transactions between the parent company and other affiliated companies is evident and the financial status of each company can be independently determined." Court of Appeals Record on Appeal at 112.

New York affiliates, which amounted to $6.1 million in 1972 and $10.8 million in 1973. Appellees do not, however, include in the same calculation the payroll, property and receipts of the non-New York affiliates whose sales generated those income figures for Export in 1972 and 1973.

By ignoring the property, payroll and sales of the non-New York affiliates in calculating the apportionment formula, while using instead the apportionment formula of the New York-connected taxpayer, appellees necessarily overstate the amount of Export's income allocable to New York and reach out to tax part of that income properly allocable to business activities which have no nexus with the State. Thus, appellees are mistaken in their assertion that the constitutionality of the tax is saved because the three-factor "allocation formula excludes the income of [the non-New York] affiliates" (Motion to Dismiss at 13). In fact, the application of the formula here does not limit New York's franchise tax to amounts " 'rationally related to "values connected with the taxing state" ' ". *F. W. Woolworth Co. v. Taxation and Revenue Dep't*, 50 U.S.L.W. at 4959 (citations omitted).

Indeed, the only thing that New York claims to have done to "exclude" non-New York affiliate income is to adjust the receipts factor of its apportionment formula by adding that portion of Export's income derived from the non-New York affiliates to the denominator, but not to the numerator, of the percentage calculation (Motion to Dismiss at 9, 13). The result is a microscopic reduction in the applicable overall allocation percentage which in no way nullifies or compensates for New York's taxation of non-New York Export income. The effect of the "exclusion" relied upon by the State is to reduce Westinghouse's allocation percentage from 6.387743% to 6.384454% for 1972 (a change of .003%) and from 6.239516% to 6.234494% for 1973 (a change of .005%). The result is that, for 1972, appellees are attempting to tax over $389,000 as New York's share of Export's $6.1 million in non-New York income, but, by virtue of an allocation formula adjustment of .003%, are "giving up" taxes on only $4,920 of the total income of

Westinghouse and Export. Similarly, for 1973 appellees are imposing New York's tax on a $671,000 share of Export's $10.8 million in non-New York income, while they "give up" taxing just $3,610 of income. Thus, the State is still taxing enormous sums of Export's income arising from business activities which have absolutely no relation to New York.

As these figures demonstrate, New York's tax scheme is patently irrational. The State is including as income of Export—and therefore taxing Westinghouse upon—the income that Export derives from the receipts of the non-New York affiliates, while it is excluding from its apportionment formula the very receipts that give rise to the income it has included. New York is thus reaching out, through its allocation formula as applied to Export's income, to tax income derived from the non-New York affiliates' receipts at a substantially higher rate than is constitutionally permissible.[2]

Moreover, because New York does not have a general policy of requiring combined reporting of affiliates and subsidiary corporations,[3] its arbitrary decision to combine part of the

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[2] For the same reasons, even if the non-New York affiliates were to be considered as part of a unitary business, the New York tax would be unconstitutional. That is, proper unitary treatment of Westinghouse, Export and the non-New York affiliates would require combining *all* of the income, receipts, expenses, assets and liabilities of *all* elements of the alleged unitary business. New York, however, has only combined a selected portion of those items—the commission income earned by Export on sales on behalf of the non-New York affiliates is included, but the receipts representing the sales themselves are not. The filing of combined franchise tax report for Westinghouse and Export, as suggested by appellees (Motion to Dismiss at 14-15), would have presented the same problem.

[3] *See* N.Y. Tax Law § 211.4 ("no combined report covering any corporation not a taxpayer [*e.g.*, a non-New York affiliate] shall be required unless . . . necessary, because of inter-company transactions . . . in order properly to reflect the tax liability . . . ."). As noted above (p.3 n.1), the Tax Department's audit of Westinghouse concluded that Westinghouse's affiliate transactions were conducted on an "arm's length" basis.

income and receipts of appellant and one of its subsidiaries but not other income and receipts of other subsidiaries denies Westinghouse equal protection of the laws. Export has been singled out for uniquely harsher tax treatment. While such differential treatment of a part of Westinghouse's business is unconstitutional in itself, the problem is exacerbated by the fact that, as noted in our Jurisdictional Statement (at 14-15), the operations singled out for harsh treatment exclusively involve foreign trade. That fact justifies particularly strict scrutiny of the lines drawn by the State in taxing appellant. *See, e.g., Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 449 (1979).

B. In addition to these violations of the Due Process, Equal Protection and Commerce Clauses, the New York tax scheme is, quite simply, irremediably inconsistent with the tax benefits that Congress granted in enacting the DISC legislation. Beyond asserting that Congress has "permitted the states to tax DISC income"— a claim apparently based on a single, isolated quotation from a witness at a committee hearing (Motion to Dismiss at 4, 15)—appellees make no showing whatever to dispute our demonstration of inconsistency between State and Federal law (Jurisdictional Statement at 13-15). The testimony of single witness (even a Treasury official) at a committee hearing does not support an interpretation of a statute plainly at odds with its overall purpose (*see S&E Contractors, Inc. v. United States*, 406 U.S. 1, 13n.9 (1972))—here to encourage domestic manufacture of goods for export. In any event, the brief and ambiguous colloquy indicates that state taxation would be allowed, at most, only to the extent that a state "is piggybacking on the Federal corporate income tax"[4] —that is, imposing corporate taxes in the same manner as the Federal government. But New York's tax scheme is at odds

[4] Hearings Before the House Committee on Ways and Means on Tax proposals Contained in the President's New Economic Policy (92d Cong., 1st Sess.) (1970) at 171.

with the Federal structure because New York is attempting to tax the half of Export's income (its "accumulated DISC income") that is exempt from current Federal taxation.[5]

And with respect to New York's attempt to tax that portion of Westinghouse Export's income that was "deemed" distributed to Westinghouse under Federal law, but not in fact distributed (about $13 million in 1972 and $19.8 million in 1973, see Motion to Dismiss at 7), this case is controlled by last Term's decision in *F.W. Woolworth Co. v. Taxation and Revenue Dep't.* There, this Court rejected New Mexico's attempt to tax income "deemed"—for purposes of computing Federal tax—as received by a corporation from non-unitary subsidiaries, but not in fact received. 50 U.S.L.W. at 4958n.6, 4961-62. "New Mexico's effort to tax this income 'deemed received'—with respect to which New Mexico contributed nothing—" was "held to contravene the Due Process Clause." *Id.* at 4962. Similarly here, New York's attempt to tax "deemed distributions" attributable to sales by Export on behalf of non-New York affiliates, but not in fact paid as cash income to Westinghouse, must be held unconstitutional.

In sum, the New York tax fails to differentiate among the different sources of Export's income and its actual receipt by Westinghouse with sufficient precision to pass constitutional

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[5] The fact that Congress did not enact a bill dealing with this general subject in 1980 (see Motion to Dismiss at 4) is, of course, irrelevant to ascertaining its intent in passing legislation in 1971. In any event, the bill referred to by appellees, H.R. 5076 (96th Cong., 2d Sess.), would have effected a comprehensive overhaul of state taxation of foreign subsidiaries and affiliates by, among other things, generally outlawing unitary taxation of foreign affiliates where only the parent did business in a state. As part of this proposal, DISCs were to be treated as foreign corporations (even though they are incorporated domestically) and thus exempted entirely from state taxation. *See* Description of H.R. 5076 Relating to State Taxation of Foreign Source Corporate Income, prepared for the Use of the Committee on Ways and Means by the Staff of the Joint Committee on Taxation (March 28, 1980) at 18-19. Appellant has not, however, claimed that a DISC may never be taxed by New York, as H.R. 5076 would have provided. Rather, our claim is that any tax must be applied in a constitutionally proper fashion.

muster. These interrelated deficiencies, which result in a failure to identify precisely and tax only that income which the State has the constitutional power to tax, vitiate New York's entire franchise tax scheme as applied to Export's income.

II. THE NEW YORK FRANCHISE TAX UNCONSTITUTIONALLY DISCRIMINATES AGAINST EXPORTS MADE FROM OUTSIDE THE STATE.

Appellees have provided no justification whatever for their discriminatory taxation of income attributable to exports shipped from a regular place of business outside the State of New York. By virtue of New York's 70% credit against tax due on accumulated DISC income, Export pays a tax equal to 9% of its income on shipments that originate outside New York but only 2.7% of its income on shipments made from within the State. That credit plainly and undeniably discriminates against exports shipped from non-New York locations by imposing a tax on income from those sales at a rate which is more than three times higher than that imposed on exports shipped from New York.

New York defends its discriminatory taxation of non-New York based export income by relying upon the generalized statement that "States are free to use their taxing power 'to encourage the growth and development of intrastate [commerce] and industry . . . [and to] compete with other [S]tates of interstate commerce . . . .' ", citing *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 336-337 (1977) (Motion to Dismiss at 16). That proposition is so abstract that it says nothing about the constitutionality of a tax which is applied at higher rates to shipments made from outside the state as compared to instate shipments. Yet it is precisely such a tax which was struck down in the case relied upon by appellees. This Court in *Boston Stock Exchange* held that a New York tax on stock transactions which, *inter alia*, reduced the tax on nonresidents whose stock sales were made in New York by 50%, as compared to the tax imposed on such sales occurring

outside New York, was barred by the Commerce Clause. This Court ruled:

> "Both the maximum tax and the rate reduction provisions of § 270-a discriminate against out-of-state sales by nonresidents . . . . A state may no more use discriminatory taxes to assure that nonresidents direct their commerce to businesses within the State than to assure that residents trade only in intrastate commerce." *Id.* at 334-335.

Appellees' attempt to justify a tax rate on non-New York export income which is 333%[6] of the rate on New York export income on the ground that locating shipment activities within New York would increase the numerator of the taxpayer's three-factor apportionment formula rests on implausible assumptions and faulty logic. First, it is inconceivable that the marginal increment in the New York apportionment factors arising from the location of some shipment facilities in the State would even remotely approach offsetting a trebling of the applicable tax rate. Second, to the extent that the facilities moved to New York are removed from jurisdictions with similar apportionment formulae, taxpayers would experience an offsetting decline in their tax exposure outside New York, thereby making the credit unnecessary as a device to limit the parent corporation's total tax liability. Third, New York's argument proves far too much. If accepted, it would mean that any state with a formula-apportioned income tax could tax income derived from shipments outside the state at rates higher than those applicable to local shipments for the purpose of inducing location of shipping facilities within the taxing jurisdiction. That is precisely the kind of discriminatory taxation which was specifically condemned by this Court in the *Boston Stock Exchange* case.

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[6] 9% + 2.7% = 333%

CONCLUSION

For the foregoing reasons, and those discussed in the Jurisdictional Statement, probable jurisdiction should be noted and the case set for argument.

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Respectfully submitted,

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